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Excessive debt accumulation was, of course, the reciprocal of the credit expansion that "heated" the prosperity. It was a prime ingredient in the financial condition that was to overtake a large sector of the economic system: illiquidity. It was, indeed, an illiquid, overexpanded colossus of debts, rather than an excessive money supply, on which the price structure of the late 1920s rested.

— Melchior Palyi, *The Twilight of Gold, 1914–1936*, 1972

ON THE ROAD TO ASSET PRICE AND DEBT DEFLATION

Apparently, the markets worldwide have awoken from their complacency about a "Goldilocks" American economy. The trouble is to identify the precise reason. The conspicuous trigger of the first sell-off in U.S. stocks was the news of a 0.6% CPI inflation rate for April, suggesting an inflation scare. But this explanation flagrantly conflicts with the fact that the prices of commodities and gold have fallen sharply, while 10-year Treasury yields have declined.

In our view, the first ominous sign of coming change has been the dollar's steady fall against all major currencies, which started many weeks ago. Considering all the different market reactions, there is but one single explanation that makes sense of them all, and that is the expectation of a distinctly slowing U.S. economy. We regard it as the first buds of this worry, to be followed by a very rude awakening after all.

In the last letter, we tried to drive home the fact that the U.S. economy is in far worse shape today than in 2000. The U.S. current account deficit over the past five years has more than doubled, from $416 billion to $850 billion. Personal savings are down from $168.5 billion to negative $33.5 billion. Government finances have swung from a surplus of $239.4 billion to a deficit of $320 billion. Indebtedness by government, businesses and consumers has soared from $18,052 billion to $26,391 billion, or 46%. Financial institutions boosted their indebtedness from $8,104 billion to $12,496 billion, or 54%. And what is the basis of this borrowing mania? Inflated asset prices.

Paradoxically, the one sector in the U.S. economy that has emerged as the solitary heavy saver, implying spending less than current income, is the one sector that in a sound economy typically does the opposite and spends more than its current income. This is the business sector, regularly borrowing for investment. In 2000, firms in the nonfinancial sector spent $300 billion in excess of their cash flow on investment. In 2005, they spent $100 billion less than their cash flow, rising sharply during the year.

In a sound economy, the main borrowers — for investment spending — are businesses, while private households provide the necessary savings. American policies have succeeded in putting this relationship between saving and investment completely on its head. During the five years from 2000–05, consumer spending and residential building accounted for 96% of GDP growth, while businesses spent considerably less than their cash flows. They do the saving for the consumer and the government. This is economic insanity.

Apparently, America's consumer is the world's economic Hercules, accomplishing this even with collapsed income growth. In 2005, the growth of real disposable income of private households was down to a record low of 1.4%, compared with 4.8% in 2000. Thanks to the government's generous tax cuts, it had been higher in the prior years.

Reading all the optimistic, even euphoric, reports about the U.S. economy, we keep wondering and wondering how they are possible in the face of a perishing housing bubble. From the perspective of growth fundamentals, the U.S. economy is not in bad shape — it is in disastrous shape.

Of course, we have been warning of this for a long time. Yet the U.S. economy keeps growing. For many people, to be sure, this proves that we are wrong. We admit to having been wrong in one respect. That is in the durability and the size of the borrowing excesses possible in the United States and several other countries. In most European countries, except England, credit excesses of this magnitude are simply unthinkable. There are neither the bankers nor the borrowers to perpetrate them.

So does this mean that they can go on indefinitely? Definitely not. The longer credit excesses continue, the worse the backlash. That used to be basic knowledge among policymakers and economists. To us, the idea of a soft landing for the U.S. economy after these unprecedented credit and debt excesses is ridiculous. With utter amazement, we read that the consensus, including international institutions, assume uninterrupted growth around 3% for the U.S. economy for years to come.

Admittedly, it is amazing that the U.S. economy, with all its imbalances, has been able to sustain its apparent impressive growth performance. But to overcome the downward pull, more and more credit and debt creation is required, already running at preposterous scale. In the end — see Melchior Palyi's quote on Page 1 — excess debt is mistaken for excess liquidity.

DEBTS OUTRUN INCOMES

First of all, we ought to once more stress a point we have made many times before. The U.S. economy's impressive growth performance during the past few years is more apparent than real. What truly matters most for people is inflation-adjusted income growth, and in the United States that is and remains at its lowest in the whole postwar period. Conveniently, this is generally ignored, compared with the better-looking phony numbers about real GDP and productivity growth.

But our focus on income growth has still another most important reason. That is the coincidence of exploding debts versus virtual income stagnation in real terms. In the end, people borrow future income. That is fine when incomes are rising, but when people pile up record debts in order to offset lacking income growth, this becomes a hazardous endeavor. Assuming maintenance of the living standard, debts have to be repaid from inflation-adjusted income, by the way.

People have been told that the soaring debts do not matter because they are outpaced by "wealth creation" through rising stock and house prices. Yes, but unfortunately, this kind of wealth creation through asset inflation in the markets, in contrast with wealth creation through capital accumulation in the economy, adds nothing to current income, from which the interest charges can be paid. Most probably, these have until recently been largely paid in the Ponzi way; that is, the lenders readily capitalize unpaid interest. But that must stop when asset prices cease to rise.

The other question is the change in the liquidity of the housing market when the general desire to buy turns into a general desire to sell. The safest thing to say is that sometime in the foreseeable future, people will awaken to the total illiquidity of the housing market, at first in the way that sales stretch out, and thereafter in falling prices.

Inflating asset prices create their own liquidity, if the central bank accommodates, and that is what the Federal Reserve has done in abundance ever since Mr. Greenspan took over in 1987. Deflating asset prices inexorably create their known illiquidity. Japanese experts keep telling American economists that their decisive bubble legacy is not the deflation of consumer and producer prices, but the savage deflation of real estate prices having devastated the banking system.

FALSE FLEXIBILITY

It seems to us that American policymakers and economists do very little thinking about these questions, if any. To all appearances, their considerations about the U.S. economy's prospects start and end with two axioms: *First*, the U.S. economy possesses an extraordinary resilience and flexibility; and *second*, American monetary policy is almighty.

We keep wondering where there is any flexibility in the U.S. economy. In essence, it implies positive flexibility in the sense of a country's ability to correct undesirable, unsustainable and damaging imbalances in the economy and the financial system, like lack of savings, a huge trade deficit or runaway indebtedness. What we see in the United States, however, is a general flat refusal to adjust. It is not even thought necessary.

Yet the U.S. economy possesses outstanding flexibility in one field, and that is in credit and debt creation, for many years running preposterously out of proportion to economic activity. Any reasonable economist will regard this kind of flexibility more as a vice than a virtue.

Mr. Greenspan and other leading members of the Fed have repeatedly shocked us with the remark that hedge funds increase the efficiency of markets. Their capital base is reported around $1 trillion. Including their leverage, this means a potential volume of activity of several trillion dollars. Of course, this makes volume and influences prices.

It is apparently assumed that the greater quantity or liquidity provided by the hedge funds implicitly means higher efficiency. Rising volume is certainly good for producing cars. But to apply this idea to the production of credit is ludicrous. A central banker who expresses this opinion reveals complete ignorance of his most important task. Efficiency of a market shows in proper pricing, and that is definitely the one thing that the hedge funds with their concentrated firepower do not provide.

The most important task of a central bank is to keep credit growth within noninflationary limits. By long tradition, the Fed takes this measure by the conventional inflation rate, nowadays the core CPI. With this rate at a historical low for years, it has fostered and tolerated a credit expansion grossly out of proportion to economic activity. It conveniently ignores that the far greater part of the credit deluge is flooding into imports of goods and asset markets, boosting prices there but leaving the CPI untouched.

Both Mr. Greenspan and Mr. Bernanke have explicitly declared to aim their rate hikes at the "neutral," or "natural," rate of interest, as defined by Knut Wicksell. In theory, this is the interest rate that exerts neither stimulative nor retarding influences on economic activity. In practice, it is the interest rates — quoting Wicksell verbatim — "*at which the demand for loan capital and the supply of savings exactly agree*." Loan capital is just another name for credit.

Basically, Wicksell was saying that credit expansion should be limited to available savings, defined as savings out of current income. Actually, this used to be a truism among economists since Adam Smith, and also for American economists. The end of this equilibrium between savings and credit from the 1970s on was the start of double-digit inflation.

Since Mr. Greenspan took over at the helm of the Fed in 1987, credit creation and savings have run preposterously out of balance. During the Fed's 18 Greenspan years, overall indebtedness has virtually quadrupled, from $10,569 billion to $38,889.3 billion, while savings out of current income plunged into negative territory. With savings in collapse, all this was pure credit inflation. But as most of this showed in soaring asset prices and a soaring trade deficit, rather than in the CPI, it has been hailed as a healthy development.

Lacking savings were replaced through prodigious carry trade, borrowing short and lending long, for which the Fed provided the liquidity and the yield curve. The desired and achieved result was artificially low interest rates. For Messrs. Greenspan and Bernanke, this represents efficient policies and efficient markets.

For American economists, it is dogma that the rate of inflation determines the level of interest rates. It is true that the two have in the past tended to move in lock step. But coincidence says nothing about causality. Every price is determined by supply and demand — so also interest rates as the price of credit or capital.

As to carry trade, it is credit inflation by definition. The decisive novelty is that the regular price inflation occurs today mainly in asset prices, rather than in the CPI. However, this kind of inflation in the United States ranks officially and popularly as desirable wealth creation. So what is wrong?

Strikingly, the world's worst economic and financial crises — the United States in the 1920s and Japan in the late 1980s — followed prolonged periods of conventional inflation rates at or close to zero. In both cases, actually, the low inflation rates in consumer and producer prices had misled the central banks to allow and foster unbridled credit excess. This is the decisive evil to look for.

One should think that those two gruesome experiences would have served as a wholesome warning to keep an eye on credit excess and asset price inflation. In America, it definitely has not. We presume the Fed has stretched the rate hikes over such a long time because it wanted as little effect on the credit expansion as possible. It was inevitable to bring short-term rates back to a more normal level.

The credit expansion has even accelerated during the rate hikes. Consumer credit expanded in the fourth quarter of 2005 by $1,235 billion at annual rate, against an increase by $838.5 billion in the second quarter of 2004, when the rate hikes started. It was a farce of credit tightening, because the Fed never tightened reserves.

Nevertheless, we see the U.S. economy at the brink of an abrupt loss of momentum. The trouble, though, is not in tight money. It is in an economy and in markets that devour incessant inordinate amounts of credit. The particular trigger for the economy will, of course, be the withering housing bubble. Yet there are other drags. Among them, we regard the trade deficit, the chronic weakness in business fixed investment and the soaring indebtedness as most important.

Mr. Greenspan and Mr. Bernanke may boast of the economy's resilience and efficiency. We see an economy and a financial system that through their growth-impairing imbalances have become increasingly addicted to incessant inordinate credit injections. It is like the drug addict who needs ever-larger injections to postpone the crisis.

For a long time already, we have been pondering the question of what will happen to the U.S. economy and its asset markets when the overall credit expansion — financial and nonfinancial — shrinks from its current annual rate of $3,000 billion to $2,000 billion (which would still rank as rampant credit excess).

The short answer is the U.S. economy and its financial markets would collapse. But please also consider the alternative that this credit deluge does continue in full force, as against drastically reduced real income growth.

WHERE IS THE STRENGTH?

Assessing the U.S. economy's further growth prospects, it should be clear that consumer income growth essentially must catch up with the growth of current spending once the housing bubble ceases to deliver the rising collateral for higher borrowing and spending. Principally, there are two possible sources for this income acceleration. One is a boom in business fixed investment, and the other is an export boom.

As to the latter, its improbability hardly needs explanation. A sharp 20–30% decline of the dollar might help the trade balance to some extent, but its harmful effects on the inflation rate and the markets would badly hurt the economy. The gross mismatch between exports and imports basically reflects excessive consumption, at the expense of saving and investment. To improve the trade deficit, this harmful shift in the use of resources would have to be reversed. Nothing of that sort is in sight.

There is no question what is needed to prevent an appreciable U.S. economic downturn when the housing bubble wears out: an immediate sharp comeback of business fixed investment. But that is not at all in sight. What modest increase there has been during the last few years reflects mostly hedonic pricing of computers. Take this away and there is stagnation at best. Consider that investment in manufacturing structures is down 38% since 2000.

Yet we note general hype. With utter amazement, we read in the London *The Economist* of May 13:

> *The [U.S.] economy has hitherto been roaring along at a wholly unsustainable pace: Output grew at an annualized rate of 4.8% in the first quarter of the year. Both labor and product markets are tight, global growth is looking ever stronger, commodity prices are soaring, the dollar is falling.*

Reading many reports, it did strike us that the U.S. economy's strength of the first quarter, following a very weak fourth quarter of 2005, appears to have decisively swayed many people toward bullishness.

The irony is *first* of all that the two quarters together were the weakest since the first quarter of 2003. *Second*, the comparison between the two quarters is heavily distorted, because the GDP measures quarterly averages. Depending on the changes within the quarters, the results can vary tremendously.

The more correct alternative is to measure from month to month, in this case from end-December 2005 to end-March 2006. Measured in this way, consumer spending rose in the first quarter of 2006 by only 3.2%, instead of the 5.5% in the GDP statistics. Using the same method, the growth rate for consumer spending in the prior fourth quarter of 2005 was 0.9% in the GDP statistics, as against 6.4% in the month-to-month statistics. Entering 2006, consumer spending in reality has drastically slowed, contrary to the impression made by GDP statistics.

Given the withering U.S. housing bubble, it is time to ponder the U.S. economy's potential downside. For us this pondering begins with the recognition that prevailing expectations and forecasts about the U.S. economy's prospects — see *The Economist* — remain absurdly high.

There was good news that personal incomes increased in March by 0.8% in current dollars and by 0.5% in chained dollars. But 58% of that increase arose from a jump in governmental transfer receipts. Absent that, there was flatness in real terms for the month and an annualized growth rate of less than 1% for the quarter.

The single most shocking recent news was certainly the employment data for April. Instead of an expected increase by 200,000, the Labor Department reported a gain of 138,000, compared with an increase by 228,000 in payroll employment during April of last year. Not only that, but a revision subtracted 36,000 jobs from the February and March data.

Very few took note of the worst part of the news. To get this dismal job growth, the Bureau of Labor Statistics created 271,000 new jobs with a stroke of the pen through its dubious "net birth/death model." According to the actual survey, there was a job loss of 133,000 jobs. Last year, the net birth/death model had produced "only" 205,000 jobs, as compared with a reported job increase of 228,000.

A deteriorating job picture should, in reality, surprise nobody, considering that the housing bubble during the past few years has been the single biggest job creator, directly and indirectly. Think of all the real estate agents and banks involved. This job creation will not only stop, but it will also turn heavily negative. Normally, one should not put much stock in one month's data, but in consideration of this background, it is highly reasonable.

PUZZLING FORECASTS

To us, the recent highly optimistic forecasts for the U.S. economy are a complete mystery. By now, it is a compelling assumption that the economy's one main engine, the housing bubble, is flagging. It has been calculated that the "wealth effects" on consumption have raised real GDP growth by 1.5 percentage points a year for the past five years. With nothing in sight to replace this monstrous asset and credit bubble, a sharp downturn of the U.S. economy is the most obvious conclusion.

The GDP numbers are easily manipulated. There is more reality in the income numbers, and even with grossly understated inflation rates, they are at their worst since 2000, because new tax cuts are missing. Real disposable income was up just 1.4% in 2005 and is slowing in 2006. And this is true even with almost 900,000 jobs added in 2005 by the net birth/death model.

On the other hand, inflation rates are on the high side. The U.S. CPI rate of 3.6%, year over year, is the highest among major countries, and that even with the huge trade deficit. It gives some food for thought that the announcement of an increase by 0.6 % in the U.S. CPI for April triggered a selling panic in global stock markets lasting several days. Among other things, this told of the shakiness of all these markets.

Mr. Bernanke is facing the worst possible dilemma for a central banker: high and accelerating inflation and

decelerating economic growth. What will emerge as his preference — fighting inflation or fighting recession? His preference, no doubt, will be the latter. But the high inflation rates, even though grossly understated, will force him to act most cautiously, far too cautiously for a strong stimulating effect on the economy. The quick and sharp rate cuts of 2001 are unrepeatable. In other words, monetary policy has very little choice.

How much economic weakness may be expected? It is a familiar postulate of Austrian theory that the extent of the bust following a boom tends to be rather proportional to the scope of the prior excesses and the adherent economic and financial imbalances that have accumulated during the boom.

This postulate of the proportionality between boom and bust has convinced us from our earliest times. Manifestly, it is diametrically opposite to conventional thinking in the United States, discarding prior boom excesses as irrelevant feats of the past. Past is past; the only thing that counts is current monetary policy. It seems to us that simple common sense revolts against this simplistic assumption.

Our dismal assessment of the U.S. economy's near-term prospects has its basic reason in the recognition that the housing bubble has involved borrowing excesses of unprecedented magnitude. Over the five years 2001–05, private households have propelled their outstanding debts from $6,960.6 billion to $11,496.6 billion. That is up 65%, which compares with a simultaneous increase in real disposable income by 12.9%, of which a large part derived from the tax cuts. In contrast, consumer spending soared over this period by 19.2%. By these and many other measures, this asset and credit bubble has gone to unusual extremes, essentially implying a rather violent downturn.

Measured against the current inflation rates, U.S. long-term interest rates remain ridiculously low. But measured against current real disposable income growth of barely 1% at annual rate recently, they are abominably high.

MONETARY CATCH-22

In its May 8 issue, *Barron's* trumpeted: *"The economy is humming, earnings are rising, and interest rates remain low. No wonder the nation's money managers are bullish. The case for a Dow 12,000, technology and energy shares… **What, me worry? Happy Days.**"*

That, thus, was the mood among institutional investors in early May, just four weeks ago. According to *Barron's* Big Money poll of institutional investors, bullishness had distinctly increased and bearishness distinctly decreased compared with the prior poll last fall. More or less, this optimism corresponded with the glowing growth forecasts of leading economists, the International Monetary Fund and the OECD in Paris included. Nobody, apparently, expected any adverse impact of significance from a termination of the housing bubble.

Observing this generally pronounced optimism, we expected, like the consensus, further strength both of the dollar and the stock market, despite our radically different assessment of the U.S. economy's prospects. The sudden dollar weakness and the sharp sell-off in the stock market, therefore, have taken us, too, rather by surprise.

The sudden general dollar weakness, which started weeks ago, is really the most ominous part in the recent development. For the relatively stable currency markets, it is a dramatic fall. Within weeks, the dollar has slumped to its lowest level since October 1997 in trade-weighted terms.

Ominously also, the stock market's first sharp sell-off happened one day after the Fed's rate hike, though it was perfectly in line with general expectations. Wondering about a connection, we took a look at the FOMC's postmeeting statement and read as follows:

> *The Committee judged that some further policy firming may yet be needed to address inflation risks but emphasizes that the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information. In any event, the Committee will respond to changes in economic prospects as needed to support the attainment of the objectives.*

According to reports, many people thought this surprisingly hawkish. To us, it said above all that the Fed is unsure about what to do. It faces the dilemma of uncomfortably high inflation rates and a weakening economy. Being moreover publicly suspected of dovishness, Mr. Bernanke had to demonstrate a little hawkishness. If that little bit was enough to upset the stock market, it only confirms to us how shaky and vulnerable it is.

Soaring commodity prices, a bull market in gold, rising long-term interest rates, stalling house prices, a falling dollar, a sliding stock market — is there any economic scenario that could explain this unpleasant mixture of market moves? Yes, there is one: stagflation — uncomfortably high inflation rates coupled with low economic growth. It seems to us highly probable that more and more disappointing economic news has awakened people to this possibility. This has, moreover, to be set against the high-riding earlier optimism.

Perhaps there is also a growing perception that the Bernanke Fed is confronting an outright Catch-22 situation. Given a weakening housing bubble, there can be no question about the U.S. economy's impending slowdown. But a weakening economy is poison for the dollar.

Ever since World War II, it has been a regular experience that the dollar strengthens when the U.S. economy grows faster than the European economies. Conversely, it regularly weakened when U.S. economic growth lagged.

The reason is that a strong economy pulls in capital faster than the U.S. current account deteriorates. In contrast, when the economy slows, its pull for foreign capital and credit diminishes in relation to the current account deficit, and now the latter takes over as the determinant of the dollar's value in the currency markets.

This is the key point about the U.S. current account deficit, which those who discard it as a nonproblem fatally overlook. This deficit becomes heavily dollar negative when the U.S. economy slows down.

By this experience, it is a safe bet that a weakening economy will send the dollar plunging in the coming months. In question is only the extent of weakness, both of the economy and the dollar. In essence, they are reciprocal.

Now the next complication to consider is that a weakening economy under these conditions will perversely affect domestic inflation, because the falling dollar will tend to boost it through higher import prices. Unfortunately, if Mr. Bernanke tries to support the weakening economy with lower interest rates, he accelerates the dollar's fall, and in its wake the rise in import prices.

In the end, he will face the choice between defending the economy or the falling dollar. American mentality requires him to defend the economy. That is what Mr. Greenspan did in 2001–03, with the result that between early 2002 and end-2004 the dollar fell by 61% against the euro and by 32% against the yen. Asian central banks prevented or cushioned a rise of their currencies by massive interventions.

Then the dollar abruptly stabilized and slightly recovered in 2005, regardless of the rapidly widening trade deficit. The main reason was that the Fed's rate hikes led to a big shift in the U.S. carry trade from funding in dollars to funding in foreign currencies with lower interest rates — yen, euro and Swiss francs. Despite those rate hikes, U.S. domestic credit demand exploded in the track of the housing bubble and soaring speculative activity.

This dollar strength in 2005 has strengthened the view that the monstrous U.S. trade deficit is sustainable for the foreseeable future without a serious dollar crisis.

OUT OF CONTROL

The decisively simple fact about the U.S. economy is that total spending exceeds total domestic output or income, and the difference of presently around $900 billion per year shows in the current account deficit. To manage such horrendous spending excess inexorably requires an extremely loose monetary policy. That is what the Greenspan Fed has by any measures readily delivered. It is as simple as that.

Now a little historical reminder. In the first half of the 1980s, the dollar soared on the back of a strong recovery against the deutsche mark from DM1.74 to DM3.47. When the U.S. economy showed the first signs of slowing in 1985, the dollar promptly tumbled. Still fearing a strong bounce-back, U.S. Treasury Secretary

James Baker convoked a conference of finance ministers and central bankers of the G-5 (The United States, Britain, Japan, Germany, France) at the Plaza Hotel in New York to stop a rise of the dollar by common interventions in the currency markets.

Barely a year later, the dollar and U.S. stocks and bonds were crashing. When the finance ministers and central bankers met again in December 1987, it was to undertake concerted action against the dollar's further free fall — the Louvre Accord. The dollar noted at DM1.63, down 53% from its top in 1985.

Could this happen again? We would not predict it, but neither do we regard it impossible. The fact to see is that in the U.S. economy and its financial system too many things are simply out of control. When dollar stability depends on heavy dollar purchases by the Chinese central bank, we regard this as "out of control," because it is not under the control of the American authorities.

With the trade of almost $1 trillion and gross foreign debts of $12 trillion, its stability manifestly depends on the whims of many people — foreign creditors, American and international investors and speculators. Just imagine American hedge funds becoming bearish on the dollar and shorting it. The thing to see is that the Fed would be absolutely powerless to stop this, because the big rate hikes to stop this would kill the economy. This is what we call "out of control."

Consider further the immense losses that the holders of dollar assets in the rising currencies will suffer. This is one other crucial difference to the situation in the 1980s. Until 1983, the United States was creditor to the world. Today, it is gross debtor by more than $13 trillion and net debtor by more than $3 trillion, growing per annum by almost $1 trillion. To repeat, this is totally "out of control."

BUBBLES, BUBBLES

Our own assessment of the U.S. economy is not data dependent. It is determined by the realization, *first*, that after five years of bubble-driven growth, the economy is in its worst shape ever and, *second*, that the crucial housing bubble is stalling.

Mr. Greenspan has been praised because he managed to replace the bursting equity bubble in 2001 with an array of other bubbles, which propelled the consumer borrowing-and-spending binge to new extremes. In our view, a desperado avoided a deeper immediate recession by policies that have disintegrated the U.S. economy as never before, spelling far greater trouble in the future.

Yet the recovery from the mild 2001 recession had a miserable start with real GDP growth of 1.6% in 2002 and 2.7% in 2003, together 4.3%. Jobs continued to fall well into 2003. This compared disastrously with the stellar growth rates of past recoveries. In their cases, real GDP over the first two years soared on average 10%, and employment by 6.6%. Well into 2003, any signs of sustained economic recovery remained missing.

Mr. Bernanke, in particular, began to muse in public speeches about the possibility of deflation. On Nov. 21, 2002, he made a speech before the National Economists Club in Washington with the title *Deflation: Making Sure "It" Doesn't Happen Again*. Expressing that *"Deflation in the United States is highly unlikely,"* he nevertheless qualified that *"it would be imprudent to rule out the possibility altogether."*

Assuring his audience that *"the Fed would take whatever means necessary to prevent significant deflation in the United States,"* he mentioned the desirability of also lowering long-term rates. To achieve this, he mentioned two possibilities *"which could be employed separately or in combination"*: *first*, a commitment by the Fed to keep short-term rates at zero for some time; and *second*, that the Fed would announce target yields, with a commitment to make unlimited purchases of securities for up to two years at prices consistent with the targeted yields.

Mr. Greenspan, on his part, caused furor with a remark in a congressional testimony on May 21, 2003: *"Indeed, we have reached a point at which, in the judgment of the Federal Open Market Committee, the probability of an unwelcome substantial fall in inflation over the next few quarters, though minor, exceeds that*

of a pickup of inflation from its already low level."

As the inflation rate continued to decline, the Fed used this to justify further cuts to the federal funds rate to the historic low of 1%. In the same vein, leading members of the Fed during the first half of 2003 began to convey two messages to the markets.

One was an explicit commitment to maintain the fed funds rate at 1% for a long time to come, and the other was hints to ponder "unconventional" measures to also lower long-term rates in order to fight an "unwelcome fall in inflation," a synonym for deflation.

These two messages were an undisguised attempt to manipulate bond prices higher and bond yields lower. Right from the beginning, it was as clear as daylight that in an economy without domestic savings, this represented an outright pledge to the financial community to engage in leveraged carry trade of long-term bonds.

Given a huge and highly vigilant speculative community in the United States, the desired bond bubble promptly kicked in with a vigorous thrust. Within weeks, the yield of 10-year government bonds slumped from a little over 4% to 3.1%, its lowest level in 45 years. In sympathy, 30-year mortgage rates fell to 5.21%, their lowest rate in more than four decades.

In its May 29 editorial, *The Wall Street Journal's* Europe edition praised the chairman for his wily gamesmanship:

> *Merely by talking about deflation, he's made the markets anticipate easier money; long-term interest rates have fallen accordingly, helping to keep housing prices afloat and to spur one more round of mortgage refinancing. This in turn feeds consumer confidence and helps keep the post-bubble economy growing. As a monetary gambit, uttering the word "deflation" has so far been a great tactical success. We suppose that's worth the price of scaring people about an economic threat that isn't very likely.*

In short, being assured by Mr. Greenspan and other Fed members that there would be no interest rate hike as far as the eye could see, investors and speculators, desperately hungry for big profits, stampeded into heavily leveraged bond purchases, giving a strong boost to mortgage refinancing through sliding long-term interest.

Closer to the truth: In the guise of worrying about deflation, Mr. Greenspan signaled to the marketplace his determination to accommodate unlimited leveraged bond purchases. Investors and speculators complied with enthusiasm, giving long-term rates another sharp downward tick. Implicitly, in a country with negative national savings, changes in the level of long-term interest rates essentially depend on changes in carry trade.

The background to all this talk about deflation was the fact that the U.S. core CPI inflation rate had declined from 2.8% in November 2001 to 1.1% in December 2003. It was, thus, never negative. Considering, moreover, that money and credit supply exploded and that reported productivity growth rose at a stellar annual rate of 4.1%, it was a preposterous scare.

Some economists of the Federal Reserve Bank of Atlanta spoiled the scare with a report in their *Economic Review* (First Quarter 2004) under the title "Decomposing Inflation." Therein, they explained in detail that rent and used vehicle prices, accounting for more than 30% of the price index, had played a dominant role in lowering the inflation rate.

As to rental prices, they elicited that their downward pressure mainly resulted from increasing demand for homeownership, spurred by record-low mortgage rates. Rising homeownership, in turn, put downward pressure on rent, the largest component in the CPI. In this way, housing became the most important factor in lowering the CPI, despite surging home prices.

As to used vehicles, the authors wrote that the sharp decline in their prices largely reflected the soaring demand for new vehicles in response to record-low financing and rebate offers. Essentially, this boosted the supply of old vehicles, depressing their prices.

In summary, the study argued that *"From November 2001… to December 2003, the contribution of rent to*

CPI core inflation fell 0.8 percentage points while the contribution from used vehicles dropped 0.3 percentage points — a total of 1.1 percentage points," marking two-thirds of the entire drop of CPI core inflation from 2.8% to 1.1% during that time period. These price changes, stated the study, were primarily caused by the *"dynamic effects of interest rates on consumer demand for substitutes."*

Basically, of course, all this said that the Fed's talk of deflation was nonsense. It goes without saying that this message from Atlanta utterly enraged the Fed in Washington, triggering some unpleasant repercussions for the authors.

The reality about the U.S. economy over the past five years is that it took an unprecedented dose of monetary and fiscal stimulus to spark the semblance of an economic recovery. What resulted is the weakest and most lopsided economic growth, with a dramatic shortfall in employment, incomes, savings and investments on the one hand and unprecedented credit and debt growth on the other.

CHINA — THE NEXT JAPAN?

The U.S. economy is one big theme in markets; China's booming economy is the other. This brings us to the roaring commodity bubble. Despite generally low inflation rates, the world is experiencing its sharpest run-up in commodity prices, widely attributed to China's boom. The basic premise is that this boom is very commodity intensive, with the result that commodity demand is outpacing potential commodity supply in the world.

We find it an ill-advised argument. For sure, China's economy is booming with strong commodity demand. But this has to be set against the U.S. economy's imminent pronounced slowdown. China's annual GDP is around $2,200 billion, as against a U.S. GDP of around $11,000 billion in real terms. Even if China's boom is much more commodity intensive, the U.S. economy's imminent sharp slowdown weighs unquestionably far more on the world and its markets.

On the official tally, China's GDP surged 10.2% in the first quarter, year on year, to $540 billion. Total fixed investment soared 27.7%. This may have accounted for three-fourths of GDP gains. Despite all contrary official talk, investment keeps increasingly outpacing consumption. Industrial output and exports are the other two components vastly outpacing GDP growth.

Consumer price inflation of 1.2% appears remarkable for an overheating economy with runaway money and credit growth. The obvious main reason is growing gluts of overcapacity across the economy exerting downward pressure on prices and profits. Meanwhile, the banking system is busy creating masses of bad loans.

With the declared intention to slow lending and investment, the People's Bank of China, the central bank, the other day announced a rise in the benchmark lending rate that financial institutions may charge customers from 5.58% to 5.85% — that is, by 27/100ths of a percentage point.

It amazed us how much acclaim this less-than-half-hearted measure found. Considering the ferocity of the investment boom, this rate hike is ridiculous. It rather revealed to us how little confidence the Chinese authorities have in the stability of their economy, and in their banking system in particular.

The decisive feature is, of course, the rigorous peg of the yuan to the dollar. To maintain this peg, the Chinese central bank has added more than $700 billion to its foreign reserves, from $156.1 billion in January 2000 to $875.1 billion in March 2006. Current dollar purchases are running at about $200 billion per year.

It is a striking fact that the start of the central bank's big dollar purchases coincides precisely with the start of the domestic credit explosion and the boom in China. The dollar purchases and the export boom to the United States gave the central bank free rein to allow a rampant credit expansion and the associated investment boom. Domestic credit during these five years far more than doubled.

The export surplus with the United States is lately around $180 billion annually. That is equivalent to 8% of China's GDP and 90% of its industrial production. China is a heavy importer from the rest of Asia.

How does this come about? Chinese exporters sell their surplus dollars to their banks, which credit them

with a corresponding amount in deposits. The banks, then, sell the dollars to the central bank, which credits them with a corresponding amount in central bank deposits. For the banks, these deposits add to their liquid reserves, or high-powered money. As these deposits bear no interest, their increase tends to push the banks into multiple credit expansion.

Normally, bank reserves are the limiting factor to credit growth. Ever since Mr. Greenspan took over at the Fed, this limiting factor has been absent in the United States. Implicitly, his loose policies flooded the whole world with dollars. But their effect in the rest of the world depends entirely on the posture of the central banks. In most Asian countries, they monetized the dollars, with the result of exploding credit. In Europe, floating exchange rates have cut the monetary link to the dollar.

INFLATION OR DEFLATION?

Pondering the question whether the recent upheavals in the markets reflect a decisive break in global asset inflation or simply a hiccup from temporary profit-taking in a long bull run, we definitely opt for the former. The ultimate reason for this assumption lies in the U.S. economy, and therein the shrinking housing bubble. Considering the horrendous sums that this bubble has made available to the American consumer through "home equity contraction," we cannot imagine a gradual solution.

Observing low inflation rates and floods of liquidity sloshing around, the consensus sees nothing that could cause a severe downturn of the U.S. economy and global asset markets. Recall what Melchior Palyi said about the 1920s in the United States: *"It was, indeed, an illiquid overexpanded colossus of debts, rather than an excessive money supply, on which the price structure of the 1920s rested."*

That is precisely our opinion about the U.S. economy and its financial system today. For us, the source of liquidity is all important. True liquidity comes from a surplus of income over spending; that is, from savings. False liquidity comes from borrowing. In a country with zero savings, all liquidity is essentially from borrowing. Nor is it a secret that it generally comes about through borrowing against rising asset prices.

Asset inflation is a self-financing inflation, as banks in many countries readily lend against rising asset prices. The problem is that it leads to inordinate reciprocal asset and credit bubbles, which fuel specific spending booms. As American policymakers and most economists hail asset inflation as "wealth creation," they are unable to see any dilemma. The only inflation they accept is rising prices in goods and services, the conventional inflation.

The other day, Stephen Roach, one of the most critical observers of the development in the United States, shocked us with a commentary in which he lauded the Chinese government for its refusal to revalue its currency.

He argued that Japan ruined its economy by heeding American advice to let the yen/dollar cross rate soar — *"fueling the mother of all asset bubbles in equities and property that ended with a sickening collapse into a protracted post-bubble deflation."* This is ludicrous. What drove Japan's destructive asset and credit bubbles was definitely not the rising yen. It would have been the surest antidote.

What propelled Japan's bubble economy into gross structural imbalances and dizzying overindebtedness was the rampant credit inflation, which the central bank unleashed with prolonged efforts to prevent the yen's rise by heavy dollar buying, flooding in this way the banking system with excess bank reserves. Credit exploded into stock prices, property prices and business fixed investment — into the three bubbles whose later collapses ravaged the economy and the banking system.

The precise cause of Japan's horrible bubble aftermath has been a bone of contention between American and Japanese economists for many years. In the American view, the decisive cause has been the protracted deflation of consumer and producer prices caused by lagging monetary easing, being also its conventional explanation of the U.S. Great Depression.

The Japanese, in contrast, blame their horrible post-bubble economic experience entirely on the savage

deflation of asset prices, in particular property prices, following their prior rampant rise. As asset prices plunged against rigid debt levels, this precipitated tremendous capital losses across the economy and the financial system. It was massive capital destruction in conjunction with massive debt deflation that were to strangle Japan's economy for many years to come.

What is debt deflation? To quote Irving Fisher, who analyzed the debt deflation of the 1930s: *"The very effort of individuals to lessen their burden of debt by selling assets increases it because of the mass effect of the stampede to liquidate in swelling each dollar owed."* In other words, heavy asset selling drives down asset prices, which drives up indebtedness. To quote Mr. Fisher again:

> *Then we have the great paradox which, I submit, is the chief secret of all great depressions: The more the debtors pay [by selling their assets], the more they owe.*
>
> *Thus, overinvestment and overspeculation are often important; but they would have far less serious results were they not conducted with borrowed money. The same is true of overconfidence. I fancy that overconfidence seldom does any great harm except when, as and if it beguiles its victims into debt.*

Mr. Fisher lost his total fortune in the stock market crash. He was America's great apostle in the 1920s, who had preached that the stable price level in consumer and producer prices over the decade reflected and guaranteed a healthy economy and healthy markets. Belatedly, he discovered that insane borrowing had driven the stock market's bull run. From this late recognition, he developed his debt-deflation theory.

CONCLUSIONS:

As to be expected, American policymakers and most economists have no other explanation for the sudden cracks in the stock market other than an inflation scare about consumer prices. This is an absurdly narrow perception of inflation.

During the five years from 2000–05, U.S. nominal GDP grew by $2.6 trillion and real GDP by $1.3 trillion. Over the same period, total indebtedness increased $12.3 trillion. The huge difference between GDP and debt growth indicates that the debts went overwhelmingly into asset purchases, fueling asset price inflation. This is where the **Great Global Inflation** has been concentrated.

Asset price inflation is self-financing because it creates the rising collateral for the borrowing that propels prices higher. With reckless bankers and borrowers, this can go to extremes. Yet there is an inexorable end. And this means overindebted borrowers have to sell their collateralized assets, driving down their prices. For further information, see the Irving Fisher quotes above.

What can Mr. Bernanke do? Nothing. A rate hike would cause panic, and so would a rate cut.

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